BUSINESS COMBINATIONS REVISITED: A TEMPORARY DEFENSE OF THE STATUS QUO

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HERE WE GO AGAIN!

Bowing to the demands of a small number of long-standing critics of the pooling-of-interests method of business combinations, the Financial Accounting Standards Board [FASB] has placed on its growing agenda the entire subject of business combinations for reconsideration. In addition to the requests stemming from conceptual disagreement, a considerable number of requests had also been received for clarification and interpretation of specific minor issues that had arisen in the area. Thus, the decision to reopen the subject was taken in lieu of handling these matters separately.

It is now more than three years since the Accounting Principles Board [APB] of the American Institute of Certified Public Accountants [AICPA] approved Opinion No. 16, *Business Combinations*, and No. 17, *Intangible Assets*. The issuance of these Opinions came after a two-year open struggle of unprecedented intensity. (At various times, lawsuits were even threatened by members of industry and Board members.) Then, this writer supported, and still does support, a strengthened pooling concept. This position rests on the conviction that the concept provides the only viable method within an historical cost framework for many types of combinations and that no other method will be feasible until fundamental changes in accounting are agreed on.

This is not to suggest that present accounting methods for business combinations should never be changed. It is merely a question of not having found the right answer to a difficult problem. This writer has always considered APB Opinions to be transitionary—a view whose validity many former Board members now freely concede, even though they were extremely reluctant to express it when the Board was alive, for fear of detracting from the authority of the Opinions.[1] When accounting theory provides results closer to economic facts than it now does, we

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1 Only once did the Board admit this point. See American Institute of Certified Public Accounts [AICPA], APB OPINION NO. 8, PENSION COSTS (1966). [Hereinafter Opinions and Statements of the APB will be cited without reference to the AICPA].

may be able to develop superior approaches to the most difficult issues of business combinations and goodwill.

It is well-known that Opinions 16 and 17 were derived from a single proposed opinion that could not gain the necessary two-thirds vote of the Board needed for approval, such was the diversity of views among the 18 members. Many members (including this writer) accepted Opinion No. 17 only because it was necessary for compromise, and because they believed that the effect upon business of the 40-year amortization requirement would be minimal (and, in many cases, avoidable, by carefully subscribing to the new pooling criteria). The drawbacks were a small price to pay for the overall gain, principally the restoration of pooling to its original posture.

If the FASB is to do justice to the question of poolings, its re-examination must explore:

1. The accounting and business environments that existed at the time Opinions 16 and 17 were under consideration, which substantially influenced their conclusion, and the extent to which these environments have, or have not, changed since.
2. The compromises that were made at the time—not only their nature but also their immediate and long-term effects.

The Accounting Environment Then and Now

In the early nineteen-sixties, just as it was getting under way, the APB suffered a serious reversal that for a time threatened to destroy its effectiveness. One of its first Opinions, concerned with the investment tax credit, was overruled by the Securities and Exchange Commission [SEC]. The profession had split on the issue and, after a traumatic struggle, the AICPA Council ultimately pronounced APB Opinions binding on its membership. The SEC, moreover, consented to an understanding that would preclude such disagreements.[2] At the same time, however, the Commission urged haste in getting on with the job of narrowing accounting alternatives.

During this disturbed period, the APB was considering the possibility of issuing a pronouncement on the basic concepts underlying financial statements. As the subcommittee studying the question struggled to reach agreement on a recommendation, it became apparent that no progress in that direction would be made unless the project were divided in two: one to deal with the concepts as they were known to exist, and the other to deal with what they should be for the future. A pronounce-

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[2] Following the investment credit debacle, the APB and SEC followed the practice of informally resolving major differences before issuing pronouncements.

ment on the former subject was finally issued, as a Statement[3] rather than as an Opinion, in October 1970—at the same time as Opinions 16 and 17. The project dealing with future concepts was chaired by the most vocal critic of present concepts, but it never got off the ground. The immensity of this task was demonstrated when the AICPA in 1971 commissioned the special Study Group on Objectives of Financial Statements, whose report was released in the fall of 1973.

In 1968, about the time the APB began its stormy discussions on business combinations, the AICPA published a research study on goodwill,[4] a follow-up of an earlier study on business combinations. The authors, two partners of Arthur Andersen, recommended that all business combinations be recorded on the purchase method and that goodwill be written off against stockholders' equity as of the date of acquisition—a proposal that very few agreed with. This recommendation required the acquired company's assets to be valued at current values while the acquiring company's assets remained at cost, since historical cost was to remain as the basic framework. Mergers were viewed as exchange transactions on which a new cost basis would be established for the acquired companies; this is the basic theory behind the purchase method.

When the Board began discussions on the subject of business combinations and goodwill, it was found that poolings vs. purchases and goodwill amortization vs. no amortization represented only two positions out of many prevailing among Board members. Some felt that a better approach to fair value was needed, others clung tenaciously to historical cost, and there were many positions and variations in between.

At the same time, there were many thorny accounting questions that were troubling the Board, not confined to the subject of business combinations but certainly relevant to it. A few of the many examples include:

1. Accounting methods for certain industries

   Oil and gas. A wide variety of generally accepted accounting principles were (and are) in use, producing considerable disparity in income results.

   Investment real estate. Accounting practices are far behind economic realities.

2. Treatment of certain items

   Marketable securities. Many institutions, pension funds, insurance companies, and conglomerates managing portfolios were using varying accounting principles for the timing of capital gains as income

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[3] APB STATEMENT NO. 4, BASIC CONCEPTS AND ACCOUNTING PRINCIPLES UNDERLYING FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES (1970).

[4] AICPA, ACCOUNTING RESEARCH STUDY NO. 18, ACCOUNTING FOR GOODWILL (1968).

and the valuation of affiliated companies. Accounting in this area was often, and still is[5] arbitrary.

Research and development. Costs can be, and are, either capitalized or expensed, or partly so.

Depreciation and inventory valuation. A large number and variety of methods are in use.

3. Financial reporting policies

Price-level financial statements. The use of these statements to supplement the historical cost statement was recommended, but not required, by the APB. Although price-level statements represent a first step toward fair value, the recommendation has been virtually ignored.

This situation was further complicated by the fact that there was as yet no way of establishing uniform approaches toward the implementation of AICPA pronouncements. The value of such uniformity was generally understood, but practicing accountants had not yet grasped the necessity of working together to achieve it. Thus, AICPA pronouncements were usually couched in general terms, allowing for the application of judgment in their use. This was before the Institute adopted the practice of issuing "unofficial" or "official" interpretations. As a consequence, the SEC became the interpreter of AICPA pronouncements (without publishing its interpretations) and "precedent" accounting became the vogue.

While all this was going on, a subtle and important change was taking place in the public mind. The public, which was heavily involved in a fluctuating bull market, was beginning to view accounting as a measurement of management performance; earnings per share [EPS], a statistic invented by the financial analysts and adopted by the SEC, became more important than absolute results. The public stockholder was not interested in the details, assuming that he could understand them. At first, the accountants resisted a concept alien to their practice; later they gave in and accepted responsibility for calculating EPS, albeit in general terms. Methods of calculating EPS were rather loose, and the situation was chaotic until APB Opinion No. 15[6] (just before 16!) provided a definitive "cookbook," with over 100 interpretations.

Pooling as a means of accounting for a merger evolved in the early fifties, principally in response to the desire to avoid recording unrealistic amounts of goodwill and otherwise inflating the balance sheet values

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[5] However, APB OPINION NO. 18, INVESTMENTS IN AFFLIATED COMPANIES (1971), has considerably standardized practice in this narrow area.

[6] APB OPINION NO. 15, EARNINGS PER SHARE (1969).

when high-priced stock was used as the merger vehicle. The SEC, historically allergic to inflating values, embraced it. Its underlying principle, concerned with a pooling of common equity interests involving no expenditure of resources (cash or debt), was certainly sound at the time. The criteria for qualifying as a pooling were spelled out in general terms in ARB No. 48.[7] But the absence of official interpretation on matters arising in connection with pooling (the SEC provided day-to-day determination of which combinations qualified) paved the way for the spread of certain dubious practices, many of which were aimed at immediately creating unrealistic EPS results. Examples include:

> Convertible preferred stock with nominal dividends, and other unusual stock issues, were employed in mergers in lieu of common stock at a time when disclosure of potential dilution by common stock equivalents was not required.
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> Merger terms often provided for future issuances of stock contingent on profitability of subsequent operations.
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> Shareholders of acquired companies were often guaranteed cash prices for their new stock (from the company's resources) if certain values were not ultimately realizable by the new shareholders. These raised the question of whether purchasing was taking place.
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> Assets of pooled companies with low-cost bases were occasionally sold off immediately by the acquiring companies for instant earnings of sizable amounts.
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> When sizable amounts of cash or debt were employed in addition to stock, a part-purchase, part-pooling accounting for one transaction was allowed.

The Business Environment Then and Now

It is not surprising that, in these circumstances, pooling fell into disrepute. Nevertheless, these practices might have been tolerated for longer than they were had it not been for the special market conditions that prevailed in the late nineteen-sixties. During this period, a continually rising stock market created a growth-oriented mentality spurred by the price/earnings multiple cult. One result was an unprecedented number of mergers, motivated to a large extent by the ability to achieve the results referred to above; the movement, in fact, reached its peak at this time.

It was only to be expected that the intensification of merger activity

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[7] AICPA, Committee on Accounting Procedure, Accounting Research Bulletin No. 48, Business Combinations (1957).

would be reflected in an increase in the objectionable pooling practices described above. Boom periods are usually characterized by a discernible lapse in financial responsibility, and the late sixties were no exception. Abuses were rife: the creation of instant EPS by means of "funny preferreds" is a notable example. Another example, bearing directly on our subject, was the widespread failure to make proper comparison with prior-year pooled results in annual reports, a laxity that produced distorted presentations until the SEC finally cracked down on the practice.[8]

Under the circumstances, a reaction was inevitable. Leading authorities, among them A. J. Briloff (of "dirty pooling" fame), called for changes,[9] and the SEC pressed the APB for action. The result was the issuance of Opinions 16 and 17,[10] re-establishing the ground rules for the use of pooling.

It should be noted that Dr. Briloff did not advocate the absolute abolition of pooling (his alternatives are not too clear), an attitude shared by many authorities, including Professor Snavely, who defended pooling,[11] and the SEC itself. After studying ARS No. 10 (on goodwill), the then chief accountant of the SEC (Andrew Barr) wrote, as follows, to the AICPA on the subject of pooling:

> There is no expenditure or disbursement of resources when stock is issued. The company issues a fractional interest in its net equity and earnings potential for which it receives a capital contribution. . . .
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> In periods of high market price levels, purchase accounting tends to introduce inflationary values into the balance sheet when the assets and intangibles of the acquired companies are valued at the market price of the stock issued. These amounts usually cannot reasonably be expected to be recovered from the earnings of the acquired companies. The financial abuses arising from such practices were an important consideration in the passage of the Securities Acts and the Public Utility Holding Company Act.
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> An acquisition for common stock is a capital transaction which increases both total assets and equity, and the acquisition of a profitable business increases the earnings of the enterprise.
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> We would have to agree that in most business combinations, one company is acquiring the other, but we do not agree that an acquisition for stock is the same as an acquisition for cash or necessarily should be accounted for in a manner similar to a cash purchase.[12]

Since 1970, the merger movement has subsided considerably. The

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8 Securities Act Release No. 4910 (June 18, 1968).

9 Briloff, *Dirty Pooling*, ACCOUNTING REV. 489-96 (July 1967).

10 APB OPINION NO. 16, BUSINESS COMBINATIONS (1970). APB OPINION NO. 17, INTANGIBLE ASSETS (1970). No further reference will be made to these Opinions.)

11 Snavely, *Pooling is Good Accounting*, FINANCIAL ANAL. J. 85-89 (Nov.-Dec. 1968).

12 Letter from Andrew Barr to the AICPA (March 1969).

indications are that recent mergers have been undertaken with greater caution than generally prevailed before 1970. Of course, the bear markets we have been experiencing have had something to do with this, but there is good reason to accord Opinions 16 and 17 much of the credit. Another major change is the elimination of abuses in the EPS area, thanks largely to APB Opinion No. 15, which, among other things, put the spotlight on dilution caused by common stock equivalents. More recently, the bear market has stimulated a considerable number of transactions in treasury stock, an activity that has a bearing on future pooling. (Treasury stock transactions will be discussed later.) These post-1970 developments suggest that reopening the pooling issue at this time is premature. At most, what is called for is a tune-up, not a major overhaul.

The Compromises of Opinion 16 and Their Effects

In evolving its opinions on business combinations, the APB was confronted with some fundamental premises of a conflicting nature. If a corporation buys a building for $1 million cash, or for $1 million worth of stock (market value), it records a value of $1 million. If it buys a corporation whose sole asset is a building worth $1 million (which is recorded on the acquired corporation's books for $100,000), issuing stock instead of cash, shouldn't it also record a value of $1 million? Most members said yes; it seemed so simple. But most poolings are *not* that simple.

Corporations are more than buildings—they involve people, products, processes, know-how, and customers, an aggregation that engenders an intangible earning power usually called "goodwill." This aggregation produces an accounting result based on historical cost concepts, EPS, which ultimately is reflected in a company's stock values, values determined by the market, not by the company. And when companies combine, these elements also combine, but in a fashion that is not always arithmetical. Given the many other areas of accounting that relate to this subject, it is easy to understand how dissension arose, and why the Board membership broke into factions according to whether they advocated pooling as then practiced, pooling reform, size-test pooling, or purchase accounting.

After a period of deadlock, the Board decided that the best it could do was to "reform" pooling. In addition, the Board agreed, in deference to an SEC request, to require amortization of goodwill (over 40 years) when purchase accounting is used. The Board's rationale in its explicit acceptance of the validity of pooling is attested to in the following passage from Opinion 16:

> *Validity of the concept.* Those who support the pooling of interests method believe that a business combination effected by issuing common stock is different from a purchase in that no corporate assets are disbursed to stockholders and the net assets of the issuing corporation are enlarged by the net assets of the corporation whose stockholders accept common stock of the combined corporation. There is no newly invested capital nor have owners withdrawn assets from the group since the stock of a corporation is not one of its assets. Accordingly, the net assets of the constitutents remain intact but combined; the stockholder groups remain intact but combined. Aggregate income is not changed since the total resources are not changed. Consequently, the historical costs and earnings of the separate corporations are appropriately combined. In a business combination effected by exchanging stock, groups of stockholders combine their resources, talents, and risks to form a new entity to carry on in combination the previous businesses and to continue their earnings streams. The sharing of risks by the constituent stockholder groups is an important element in a business combination effected by exchanging stock. By pooling equity interests, each group continues to maintain risk elements of its former investment and they mutually exchange risks and benefits. . . . The fractional interests in the common enterprise are reallocated—risks are rearranged among the stockholder groups outside the corporate entity. . . . Each stockholder group in a pooling of interests gives up its interests in assets formerly held in addition to an interest in the assets of the other. The clearest example of this type of combination is one in which both groups surrender their stock and receive in exchange stock of a new corporation. *The fact that one of the corporations usually issues its stock in exchange for that of the other does not alter the substance of the transaction. . . .* [*emphasis supplied*]

Implementing the Board's decision to reform pooling, Opinion 16 set forth a number of requirements that combinations would have to meet to qualify as poolings of interest. Perhaps because they resulted from compromise, heavily influenced by the antipoolers who were anxious to restrict poolings at any cost and mindful of the alleged abuses (on which there was not complete agreement), these criteria are not always as simple as might be expected:

1. The parties combining must be entirely independent companies merged through an exchange of voting common stock for voting common stock (in uniform proportion) in a single transaction with no strings or contingencies (future payments or stock issuances).
2. The equity interests of the companies must not have changed within two years prior to combination and no treasury shares can be acquired between initiation and completion of the combination (to prevent

restructuring of capitalization and bail-outs by means of large treasury stock acquisitions).

3. No cash may be involved, and no plan may be entered into for reacquiring the shares or otherwise assuring a cash realization to the shareholders of the acquired company.
4. No significant assets may be sold within two years after the combination.[13]
5. Combinations entered into shortly after year-end date cannot be reflected retroactively. This prevents a company from papering over its losses by pooling with a profitable company after its year-end.

In addition, disclosure requirements were strengthened in order to avoid any misleading implications.

Opinion 16 eliminated or modified certain requirements for qualifying as a pooling that the Board, or its predecessor, had previously supported in various pronouncements. One of these requirements concerned the relative size of the constituent companies. As proposed in ARB 48, this so-called size test would be based on a ratio of no more than 20 to 1. This proved a feeble restraint in the nineteen-fifties, and eroded quickly; the reformers were soon calling for limits of 3 to 1 and even 2 to 1. The same view was gaining ground in the United Kingdom. Nevertheless, after considerable and often acrimonious debate, the Board agreed—by a bare two-thirds majority—that the relative-size criterion simply could not support an accounting principle, and the size test was dropped. Even the then chief accountant of the SEC concurred with this view, although his opinion, expressed some time before Opinion 16, was his own and did not reflect the Commission's view.[14]

The requirement for continuity of ownership interest was clarified. Previously, continuity of interest had been interpreted to mean that shareholders (of the acquired company) could not dispose of their new shares immediately. (Practice at that time had, however, allowed dispositions of about 25 percent.) But shares of stock are as fungible as grains of wheat, and a shareholder should be entitled to sell his shares (or buy shares) before or after a business combination. Such a transaction, moreover, does not alter the continued existence of ownership interest (one shareholder merely replaces another), unless the shares are redeemed by the company, since it is the *shares* that represent the ownership interest rather than the *holders*. Then, too, there is no justification in accounting theory for restricting such sales on the acquired side

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[13] If so, the resultant gain or loss is treated as an extraordinary item, a condition that remains in effect even though extraordinary items are now severely limited under APB OPINION NO. 30, REPORTING THE RESULTS OF OPERATIONS (1973).

[14] *See* Barr *supra*, note 12.

of a combination and not on the acquiring side. Reflecting these considerations, Opinion 16 permitted the shareholders of both constituents to trade shares in the open market before and after the combination. However, the *companies* were prohibited from the following actions, in the two-year period before pooling: (a) buying shares from shareholders so as to shrink capitalization in anticipation of a pooling, and (b) using company resources (or guarantees) in subsequent trades of the "selling" stockholders.

This position cleared the air considerably. In the past, it had been common practice to partially liquidate a company (for cash) prior to pooling to enable certain controlling shareholders to obtain cash, or for the acquiring company to limit its acquisition to that portion of the company it wished to continue operating by arranging for the acquired company to declare a liquidating dividend to the old shareholders beforehand.

Antipoolers often cite the purchase of treasury shares as a particularly objectionable pooling practice. They hold that since the shares can then be used by the company in poolings, such purchases are equivalent to using cash for a business combination, which calls for purchase accounting. This is irrelevant to poolers if the purchases are made on the open market or from persons unrelated to a prospective combination; a company is always entitled to shrink its capital, or trade its shares, if the trades do not involve constituents to a pooling or a proposed pooling. The antipoolers were persuaded to accept purchase of treasury shares when clearly undertaken not for pooling but for other purposes such as stock options and stock-purchase plans. Reference was made to a "systematic pattern" of treasury purchasing as a criterion for these purposes. This compromise was not satisfactory to either party, and the controversy has continued.

In an attempt to resolve the question, the SEC issued ASR No. 146,[15] which went beyond Opinion 16 and proposed severe restrictions on the purchase of treasury shares to provide stock for stock options, purchase plans, or for the conversion of convertible preferreds and debt. In the present bear market, companies have considered their own stock an exceptional investment, and have made substantial treasury stock purchases, which they hope to use to redeem outstanding convertible stocks and bonds at a later date when prices recover. The SEC now contemplates placing severe limitations on treasury share purchases of this type. Un-

[15] SEC, Accounting Series Release No. 146 (Aug. 24, 1973).

der pressure from the profession, however, the SEC suspended the effectiveness of ASR No. 146, pending further study.[16]

This writer is forced to admit his total inability to perceive the relevance of treasury share purchases in the open market to a pooling that is not contemplated at the time. If a company can shrink its capitalization in the open market *after* a pooling (as is permitted), why can't it do it *before* a pooling, if the market is right. Unless the "selling" stockholders in a pooling receive cash for their shares, cash is not involved and the pooling concept is not violated. The continued refusal of antipoolers to accept this argument, principally because they see no difference between the use of cash or stock in a business combination, has burdened us with a compromise that has no basis in logic. Obviously, further reconsideration of this issue is needed.

The Problems of Purchase Accounting

Opinion 16 did away with the freedom to choose between the pooling method and the purchase method. In effect, the method is now dictated by the terms of the exchange. Any combination not meeting the strict criteria for a pooling must be recorded as a purchase. Of course, it is a simple matter to structure the combination as either, if both groups of shareholders are open-minded regarding the manner in which the merger or acquisition is to be effected. When stock is used in a purchase, however, and market values are high, the accounting consequences of the purchase method are awesome, because of the required restatement of asset values of the acquired company to market value and the consequent amortization of goodwill. Under these conditions, pencils are sharpened if the pooling method is not available. In the final analysis, there is every reason to believe that the new rule has made for sounder mergers.

When the purchase method is brought into play by the use of cash or debt, the costs (fair value) ascribed to the assets purchased are presumed to be readily measurable in the aggregate (the total purchase price), and there remains only the task of allocation. Most accountants agree that the excess of such aggregate value over the values ascribed to tangibles and specific intangibles is an indefinite intangible representing many factors—an excess commonly described as "goodwill." But when stock or assets instead of cash or debt are used in the purchase of an oper-

16 Securities Act Release No. 5429 (Oct. 5, 1973). ASR 146 was reinstated however in SEC Accounting-Series Release No. 146A (Apr. 11, 1974), which, among other modifications, removed the taint from treasury stock purchased prior to April 11, 1974 that did not conform.

ating company, the determination of the purchase price or "cost" as used in accounting is not so easy. Opinion No. 16 says:

> The fair value of an asset received for stock issued may not be reliably determinable, or the fair value of an asset acquired in an exchange may be more reliably determinable than the fair value of a noncash asset given up. Restraints on measurement have led to the practical rule that assets acquired for other than cash, including shares of stock issued, should be stated at 'cost' when they are acquired and 'cost may be determined either by the fair value of the consideration given or by the fair value of the property acquired, whichever is the more clearly evident.

In practical terms, this means that, since goodwill (in all its facets) is always one of the assets acquired in the purchase of an operating company, the purchased company cannot be specifically valued by reference to values of the assets. Its "purchase price" is therefore determined by the fair value of the securities issued, and, for this purpose, market quotations are generally used. This is the approach being followed today in most business combinations employing the purchase method.

It is no secret that share values may bear little or no relation to the underlying asset values at certain times. In an exchange of stock for stock of two publicly traded stocks, the exchange rates are usually predicated on the relative market quotes (plus a "sweetener"). Using the market values of the shares issued as a basis of valuation, the accounting result can thus be horrendous under the purchase method. If the aggregate market value of the shares issued is less than the book value of the acquired company, a condition common in bear markets, the assets will be written down, producing an increase in earnings (from lower depreciation) that would not reflect economic reality. If the market value of the shares is *greater* than the book value acquired, a condition associated with bull markets, the resultant lower earnings (from increased depreciation and amortization of goodwill) would be equally misleading. In view of the fact that a bear market seems to be the order of the day, this consideration has immediate relevance.

At present, the stocks of many companies are being traded at values far below book value. A good example is American Airlines, which, at December 31, 1972, had a book value of about $21 per share. In December 1973, it was trading in the neighborhood of $8 per share. An aggressive and enterprising company could offer its shares at an exchange value of $10-11 per share (assuming CAB permission is granted) and effect a pooling. Under the purchase method, the net assets of American Airlines would have to be written down approximately 50 percent (about $290 million), and future earnings would be raised by a consequent reduction of about $25 million in depreciation. Thus, a losing company might suddenly become a profitable company! This is unrealistic from either an accounting or an economic standpoint. It should be apparent that depressed market values have no relationship to the value of underlying assets; and the same is true of inflated market values.

To further demonstrate the fallacy of the purchase method, some examples of poolings that took place during the bull market of the late sixties are given in the Appendix. These examples, involving mergers between publicly traded companies, show how the mergers would have been reflected under the purchase method and what they would look like if current stock values were used. The examples were specially selected because it is believed that they conform to the more important pooling criteria contained in Opinion 16—this was rare in the sixties. Thus, they represent exchanges of voting common stock for voting common stock of publicly traded companies at exchange ratios reflecting the relative stock values at the time, plus a small sweetener to induce stockholders to accept the offer.

In each case, it is clear that if the purchase method had been applied and market quotations used as the measurement of underlying asset value, there would have been a need to inflate both tangible and intangible assets by amounts ranging from $12 to $151 million. There is every indication that it would have been impossible to avoid ascribing large portions of these excess amounts to goodwill and amortizing them over a 40-year period in accordance with Opinion 17. The combination of such amortization and the increased depreciation on written-up tangibles would have depressed their earnings severely. If the shares that were originally issued are now valued on the basis of November 30, 1973, stock prices, these same assets would require adjustments ranging from a *deficiency* of $22 million (actual write-down from original book values) to an excess of only $45 million. Of course, this shows what a bear market can do to stock values, but, more to the point, it shows that the use of the purchase method coupled with stock market values that can fluctuate severely can be distorting.

Referring specifically to the first illustration in the Appendix, one can visualize the effect of applying market values in the application of the purchase method. The merger between Litton Industries and Stouffer Foods on March 31, 1967, was effected at a time when Litton common was selling at $104 per share, Stouffer was selling at $27 a share, and an exchange ratio of .312 of Litton for 1 of Stouffer was used. If purchase accounting had been applied, the net assets of Stouffer would have had to be written up by $66 million, or 218 percent. At November 30, 1973, Litton was selling for $9 per share (adjusted). While many subsequent factors may have a bearing on this depreciation in market value, it would appear that the Litton value in 1967 was inflated (as was Stouffer's) and that placing such a value on the Stouffer assets would have been unrealistic. When the market values of both constituents are inflated (as was the case in this illustration), pooling preserves some reasonableness in the accounting.

Admittedly there is one major flaw in this exercise: It is doubtful that the mergers would have taken place if purchase accounting had been mandatory. "As if" research in accounting is always subject to this sort of consideration, especially since it is well known that management is unwilling to enter into a transaction if the accounting result proves unrealistic. Unfortunately, the use of stock market values or market sales not involving the company itself is becoming more prevalent in accounting. It has occurred in certain instances in which corporate ownership changed hands through substantial public offerings of stock. The SEC is considering the imposition of purchase accounting whenever 50 percent or more of the common stock of a company changes ownership, and recently the Commission asked the FASB for a determination on this question. In one case, where 100 percent ownership of a subsidiary was sold to the public, the SEC insisted on a revaluation of the net assets to conform with the proceeds of the offering.[17]

Conclusion—Quo Vadimus

The pooling method of accounting for business combinations makes it possible to report the results of the constituent companies' operations subsequent to combination on the same historical basis as before it, so that meaningful comparisons may be drawn. The tendency to inject stock market values into accounting valuations of underlying assets should be suppressed for the present. Assuming that the old abuses of pooling have been substantially curtailed by the strict standards laid down in Opinion 16—and many believe this to be a fair assumption—it would seem that, for the time being, pooling will have a place in corporate accounting as long as the accounting profession continues to use the historical cost method as the universal basis for determination of earnings.

Purchase accounting, while it has the advantage of updating the tangible values for one constituent of the combination, has drawbacks that far outweigh this advantage. The most important of these are:

1. *The failure to provide informative comparisons with past results.* The fact that only one constituent of a business combination is "fair

[17] See Hughes Tool Company prospectus dated December 1972.

valued" hardly makes for a useful comparison with past results (except where the assets comprise a very small part of the total assets of the combined constituents). Furthermore, even if it *were* possible to fair value *both* constituents, it is extremely doubtful that an informative comparison would be feasible, because, thanks to the inadequacy of our present standards of measurement, the accountant's determination of fair value may not even approximate true value. If we cannot agree on the proper accounting for portfolios of marketable securities, oil discovery and development, and investment real estate, how can we agree on the value of a block of stock given in exchange for stock or for the package of assets, tangible and intangible, that the stock represents?

2. *The unrealistic approach to goodwill.* Assuming that meaningful values could be determined for business combinations, we must still face the problem of goodwill. Today, the concept of goodwill is applied to a wide variety of situations. Accountants can no longer indiscriminately label it with universal descriptions such as "the tendency of customers to continue" or "the purchase of earnings in excess of a return on tangible assets."

Properly speaking, goodwill in business combinations is the excess of a cash purchase price over the fair value of tangibles and intangibles that can be identified. This excess represents an intangible that is attributable to certain factors, some of which are very difficult to pin down. These factors tend to vary between businesses (especially between non-capital-intensive businesses). Consider the following situations: A one-product company manufacturing a gadget presently popular with the adolescent market; a popular soft-drink bottler with a (no-cost) perpetual franchise and established routes; a research organization with a record of scientific discoveries and successful development of scientific products; a multiproduct company engaged in the manufacture and distribution of name-brand foods; and a successful retail chain-store operation.

Is it not reasonable to suppose that in these different business operations, the excess will be attributable to different factors? Careful analysis will probably show that goodwill arising in different transactions possesses different attributes calling for different accounting.

While the varying aspects of goodwill have been recognized in a general way, the problem has not been given the consideration it deserves. This consideration may not be feasible until the objectives of accounting are defined. In the meantime, a number of approaches have been proposed. These vary considerably in validity, but even the best cannot be recommended without major reservations. The most important of these proposed approaches are: Immediate write-off to equity—an evasion rather than a solution; permanent capitalization until loss of value becomes observable; amortization to income—which creates a distortion of income produced by the goodwill; and the creation of separate asset and equity accounts reduced periodically on an arbitrary basis. This last recommendation is associated with the new chief accountant of the SEC, John C. Burton, who advanced it in a Financial Executives Institute study, which, by his admission, cannot be defended on the grounds of absolute truth or even revelation.[18]

3. *The prevalence of mixed bases that would result if purchase or new-entity accounting resting on fair value were permitted at this time.* This mixture of bases would be confusing and meaningless to the readers of financial statements. This writer does not oppose the concept of the ultimate use of fair value basis accounting or valuation bases that depart from present generally accepted accounting principles. But these issues should not be attacked piecemeal; what is needed is a significant research effort to determine what valuation bases can best serve the measurement bases of financial statements as a whole. Now that the Study Group on Accounting Objectives has issued its report, the subject needs full exposition, and agreement must be reached on this basic issue. Only then will it be worthwhile to reopen the difficult issues of poolings vs. purchases and goodwill.

A Concluding Plea

The action of the FASB in reopening consideration of basic combination principles is inappropriate at this time. We have not yet resolved the many burning issues inherent in historical cost accounting—marketable securities, oil and gas accounting, investment real estate, depreciation, inventory valuation, price level, etc. Many, if not most, of these subjects will not be resolved until the fundamental framework of accounting for the future is determined. Despite the precision with which reported results regularly appear, accounting has not yet matured to the point where we can assume that it is measuring performance adequately. To tinker with business combinations, which is perhaps the most sophisticated area of accounting, without resolving these basic issues, would be a repudiation of good sense.

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[18] J. Burton, Accounting for Business Combinations (1970) (Financial Executives Research Foundation).

APPENDIX

COMPARISON OF ACCOUNTING FOR BUSINESS COMBINATIONS ON POOLED BASIS, PURCHASE B

Issuing company	LITTON INDUSTRIES, INC.		TELEDYNE, INC.	
Other combining company	STOUFFER FOODS CORP.		RODNEY METALS, INC	
Combination valuation date	March 31, 1967		December 1, 1967	
	No. of Common Shares Outstanding	Market Quotation Per Share	No. of Common Shares Outstanding	Market Quotation Per Share
At combination valuation date (Note 3):				
Issuing company	21,460,100	$104.25	8,470,000	$134.00
Other combining company	2,956,590	27.00	925,000	36.63
Shares to be issued in combination	922,456		290,000	
Exchange ratio	.312 for 1		.31351 for 1	
Issuing company's market quotation per common share at November 30, 1973 (Note 3)	$9.21		$24.78	
	In Dollars (000 omitted)	%	In Dollars (000 omitted)	%
Net assets acquired on pooled basis (Note 4):				
Issuing company	$ 402,500	93	$ 153,090	94
Other combining company	30,250	7	10,150	6
	$ 432,750	100	$ 163,240	100
If combination accounted for on a purchase basis, excess (deficiency) of cost over carrying basis of other combining company's net assets based on market quotations at (Note 3):				
Combination valuation date	$ 65,920	218	$ 28,710	283
November 30, 1973	(21,750)	(72)	(2,960)	(29)
Net change	($ 87,670)	(290)	($ 31,670)	(312)
If combination accounted for on a "new-entity" basis (Note 5), excess (deficiency) of cost over carrying basis of both constituents' net assets based on market quotations at (Note 3):				
Combination valuation date	$1,913,700	442	$1,011,190	619
November 30, 1973	(213,480)	(49)	54,400	33
	Aggregate (000 omitted)	Per Common Share	Aggregate (000 omitted)	Per Common Sh
Net assets attributable to common equity (Note 6): pooled basis	$ 302,050	$ 13.49	$ 143,510	$ 16.38
Based on market quotations at combination valuation date (Note 3):				
Purchase basis	367,970	16.44	172,220	19.66
New-entity basis	2,215,750	98.99	1,154,700	131.82

(12/27/73)

NOTES:

1. Combinations represent (a) acquisitions involving common for common or commo net assets and business, and (b) constituents both publicly held.
2. Dollars approximated to the nearest ten-thousandths, except for per share amounts.
3. Market quotations represent (a) at combination valuation date, the closing sales pric the day preceding public announcement of the proposed combination or day approxi ing date of acquisition agreement, and (b) at November 30, 1973, the closing sales adjusted for stock splits and stock dividends since date of combination.
4. Net assets acquired on pooled basis derived from pro forma financial data include proxy statement relating to proposed combination.

APPENDIX (Cont'd)
AND NEW-ENTITY BASIS (NOTES 1 AND 2)

TRANSAMERICA CORP. TRANS INTERNATIONAL AIRLINES CORP. January 17, 1968		AMFAC, INC. FRED HARVEY March 15, 1968		FOREMOST-McKESSON, INC. "21" BRANDS, INC. September 2, 1969	
No. of Common Shares Outstanding	Market Quotation Per Share	No. of Common Shares Outstanding	Market Quotation Per Share	No. of Common Shares Outstanding	Market Quotation Per Share
23,643,663	$53.63	2,466,184	$39.62	11,033,412	$27.12
6,276,768	25.38	484,800	36.00	2,678,275	9.25
3,138,384		533,280		1,004,353	
1 for 2		1.1 for 1		.375 for 1	
$19.97		$28.88		$11.63	
In Dollars (000 omitted)	%	In Dollars (000 omitted)	%	In Dollars (000 omitted)	%
$ 565,470	97	$ 82,050	90	$ 190,990	94
17,250	3	9,170	10	13,120	6
$ 582,720	100	$ 91,220	100	$ 204,110	100
$ 151,050	876	$ 11,960	130	$ 14,120	108
45,440	263	6,230	68	(1,440)	(11)
($ 105,610)	(613)	($ 5,730)	(62)	($ 15,560)	(119)
$ 910,920	156	$ 27,630	30	$ 207,820	102
9,680	2	(4,610)	(5)	21,240	10
Aggregate (000 omitted)	Per Common Share	Aggregate (000 omitted)	Per Common Share	Aggregate (000 omitted)	Per Common Share
$ 525,270	$19.61	$ 91,220	$30.41	$ 118,700	$ 9.86
676,320	25.25	103,180	34.40	132,820	11.03
1,436,190	53.63	118,850	39.62	326,520	27.12

"New-entity" basis, as used here, refers to use of market quote of *each* constituent to a combination as the basis for asset revaluation of the respective constituents (not a generally accepted accounting principle), following the logic that if one constituent is so valued so should the other be. It should not be confused with a new-entity approach sometimes advocated, in which both sides revalue (to current value) all tangible and specific intangible assets, and goodwill is ignored.
"Net assets attributable to common equity" gives effect to involuntary liquidation value of preferred stock where applicable.